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No. 537

Supreme Court of the United States

October Term, 1963

NORDEN-KELLY CORPORATION (formerly Kelly Instrument Corporation), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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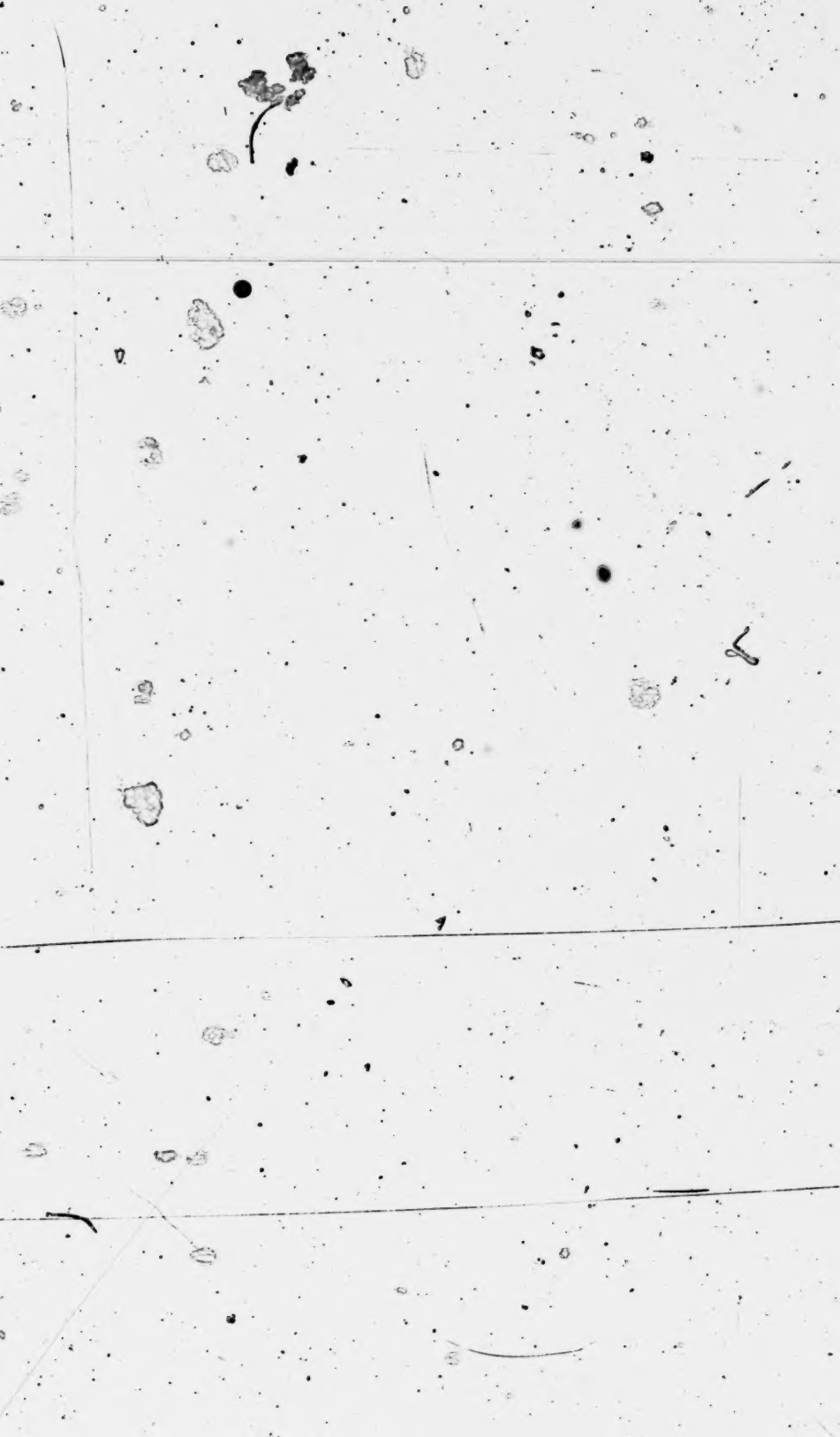


INDEX

	Page
Petition for Writ of Certiorari	1
I. Opinions Below	1
II. Jurisdiction	2
III. Question Presented	2
IV. Statutes Involved	3
V. Statement of the Case	4
(A) Brief Summary	5
(B) Detailed Statement	5
VI. Reasons for Granting the Writ	19
(A) Conflict Between Circuit Courts	19
(B) Current Importance	30
VII. Conclusion	39
Appendix	1a
I. Opinion of the United States Court of Appeals for the Second Circuit	1a
II. Judgment of the United States Court of Appeals for the Second Circuit	9a
III. Orders of the United States Court of Appeals for the Second Circuit Denying Petitions for Rehearing	10a
A. Order Denying Petition for Rehearing	10a
B. Order Denying Petition for Rehearing In Banc	10a
IV. Memorandum Findings of Fact and Opinion of the Tax Court of the United States	11a
V. Order and Decision of the Tax Court of the United States	23a
VI. Statutes Involved	24a
A. Allowance of Petitioner's Net Operating Loss	24a
1. Application of Internal Revenue Codes of 1939 and 1954	24a
2. Text of Section 172 of the Internal Revenue Code of 1954	25a

Page

B. Section 129 of the Internal Revenue Code of 1939 and Section 269 of the Internal Revenue Code of 1954 ... 32a

1. Effective Dates ... 32a
2. Text of Section 129 ... 32a
3. Text of Section 269 ... 34a

C. Section 382 of the Internal Revenue Code of 1954 ... 35a

1. Effective Date ... 35a
2. Text of Subsection 382(a) ... 36a

VII. Pertinent Revenue Rulings ... 38a

A. Text of Rev. Rul. 58-603 ... 38a
B. Text of Rev. Rul. 59-395 ... 38a
C. Text of Rev. Rul. 63-40 ... 45a

TABLE OF AUTHORITIES

I. Decisions.

A. B. & Container Corp., 14 T.C. 842 (1950) ... 29
Alprosa Watch Corporation, 11 T.C. 240 (1948) ... 29, 34 n. 13
British Motor Car Distributors, Ltd., 31 T.C. 437 (1958), *rev'd*, 278 F.2d 392 (9th Cir. 1960) ... 34 n. 13
Clifford, Helvering v., 309 U.S. 331 (1940) ... 23, 23 n. 9
Gallo Winery, E. & J. v. *Commissioner*, 227 F.2d 699 (9th Cir. 1955), *rev'g*, 12 CCH TCM 414, 22 P-H TCM ¶ 53,131 (1953) ... 24 n. 11
Glenshaw Glass Co., Commissioner v., 348 U.S. 426 (1955) ... 2
Hawaiian Trust Company, Limited v. *United States*, 291 F.2d 761 (9th Cir. 1961) ... 19, 20, 20 n. 8, 21, 30
Hughes Tool Company v. *Commissioner*, 147 F.2d 967 (5th Cir. 1945) ... 24 n. 12
Kimbell-Diamond Milling Company, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951) ... 17 n. 6
Koppers Company, Inc. v. *United States*, 134 F. Supp. 290 (Ct. Cl. 1955), *cert. denied*, 353 U.S. 983 (1957) ... 24 n. 12
Libson Shops, Inc. v. *Koehler*, 353 U.S. 382 (1957), *aff'g*, 229 F.2d 220 (8th Cir. 1956), *aff'g*, 55-2 USTC ¶ 9458 (E.D. Mo. 1955) ... 19, 23, 24, 25, 27, 28, 29, 30, 31, 32, 33, 36
Metropolitan Edison Company, Helvering v., 306 U.S. 522 (1939) ... 24 n. 12

Page

Mill Ridge Coal Company v. *Patterson*, 264 F.2d 713 (5th Cir. 1959), *cert. denied*, 361 U.S. 816 (1959) ..... 34 n. 13
M. O. J. Corporation, United States v., 274 F.2d 713 (5th Cir. 1960) ..... 17 n. 6
New Colonial Ice Company v. *Helvering*, 292 U.S. 435 (1934), *aff'g*, 66 F.2d 480 (2nd Cir. 1933), *aff'g*, 24 B.T.A. 886 (1931) ..... 24 n. 10
Newmarket Manufacturing Company v. *United States*, 233 F.2d 493 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957) ..... 24 n. 12
Norden-Ketay Corporation v. *Commissioner*, 319 F.2d 902 (2nd Cir. 1963), *aff'g*, 21 CCH TCM 1316, 31 P-H TCM ¶ 62,248 (1962) 2, 1a, 11a
Northway Securities Co., 23 B.T.A. 532 (1931) 29
Reo Motors, Inc. v. *Commissioner*, 338 U.S. 442 (1950) 2
Snyder, Thomas E., Sons Co., 34 T.C. 400 (1960), *aff'd*, 288 F.2d 36 (7th Cir. 1961), *cert. denied*, 368 U.S. 823 (1961) ..... 34 n. 13
Southgate Corporation, Early v., 136 F.2d 217 (4th Cir. 1943) ..... 24 n. 12
Stanton Brewery, Inc., The v. *Commissioner*, 176 F.2d 573 (2nd Cir. 1949) ..... 24 n. 12
W A G E, Inc., 19 T.C. 249 (1952) 29

II. Statutes.

A. Jurisdiction of This Court and Courts Below.

62 Stat. 928, June 25, 1948, 28 U.S.C. § 1254 (1958 ed.) 2

62 Stat. 961, June 25, 1948, 63 Stat. 104, May 24, 1949, 28 U.S.C. § 2101 (1958 ed.) 2

68A Stat. 800, Aug. 16, 1954, 26 U.S.C. § 7482 (1958 ed.) 2, 4

68A Stat. 771, Aug. 16, 1954, 26 U.S.C. § 6213 (1958 ed.) 4

68A Stat. 773, Aug. 16, 1954, 26 U.S.C. § 6214 (1958 ed.) 4

B. Internal Revenue Code of 1954.

§ 167(b)(2), 68A Stat. 51, Aug. 16, 1954 37

§ 167(b)(3) 37

§ 167(b)(4) 37

Page

§ 172, 68A Stat. 63, Aug. 16, 1954, 72 Stat. 1611, 1656, 1678, Sept. 2, 1958 ..... 3, 32, 24a, 25a

§ 172(a) 3, 24a

§ 172(e) 24a

§ 172(g)(1) 24a

§ 269, 68A Stat. 80, Aug. 16, 1954 ..... 3, 12 n. 4, 34, 39, 32a, 34a

§ 318(a)(3), 68A Stat. 99, Aug. 16, 1954 ..... 36 n. 14

§ 382, 68A Stat. 129, Aug. 16, 1954 39

§ 382(a) ..... 3, 33, 34, 35, 36 n. 14, 35a, 36a

§ 382(a)(3) ..... 36 n. 14

§ 394(b), 68A Stat. 133, Aug. 16, 1954 ..... 36 n. 14

§ 671-§ 677, 68A Stat. 226-231, Aug. 16, 1954 ..... 23 n. 9

§ 7851(a)(1)(A), 68A Stat. 919, Aug. 16, 1954 ..... 24a

C. Internal Revenue Code of 1939.

§ 122(a), 53 Stat. 867, June 29, 1939, 56 Stat. 807, October 21, 1942 ..... 25a

§ 122(b)(1)(B), 53 Stat. 867, June 29, 1939, 56 Stat. 847, 848, October 21, 1942, 64 Stat. 938, September 23, 1950 ..... 25a

§ 122(b)(2)(B), 53 Stat. 867, June 29, 1939, 56 Stat. 847, 848, October 21, 1942, 64 Stat. 938, September 23, 1950 ..... 25a

§ 129, 58 Stat. 47, February 25, 1944 ..... 3, 34, 12 n. 4, 34 n. 13, 32a

III. Internal Revenue Service Publications.

Rev. Rul. 58-603, 1958-2 Cum. Bull. 147 ..... 4, 31, 38a

Rev. Rul. 59-395, 1959-2 Cum. Bull. 475 ..... 4, 31, 38a

Rev. Rul. 63-40, 1963-12 Int. Rev. B. U. 8 ..... 4, 33, 34, 35, 38, 39, 45a

Rev. Proc. 62-21, 1962 Cum. Bull. 418 37

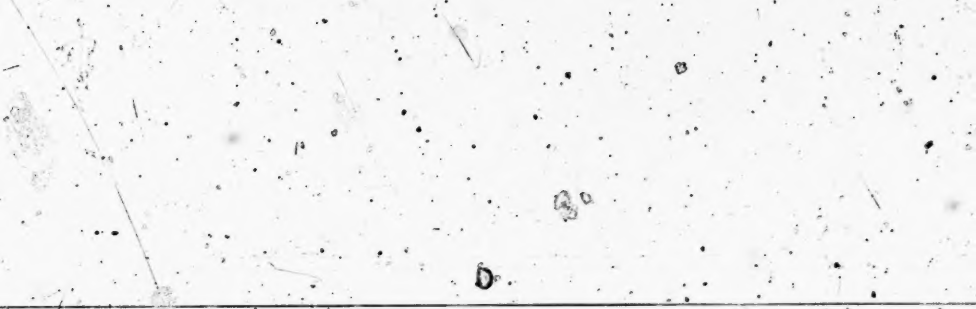
Page.

IV. Legislative History.

H.R. Rep. No. 855, 76th Cong., 1st Sess. 9 (1939) 37
H.R. Rep. No. 2087, 80th Cong., 2nd Sess. 2-3 (1948) 38

V. Miscellaneous.

Tax Management Memorandums, July 9, 1962, p. 6 32
Tax Management Memorandums, Sept. 3, 1962, p. 5 32
Program and Committee Reports, 1962, Section of Taxation, American Bar Association, pp. 47-49 33



Supreme Court of the United States

OCTOBER TERM, 1963

No.

NORDEN-KETAY CORPORATION (formerly Ketay Instrument Corporation), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in the above cause on June 28, 1963 [App. p. 9a],[1] affirming an order and decision of the Tax Court of the United States entered on October 24, 1962 [App. p. 23a].

I. OPINIONS BELOW

The Tax Court of the United States filed its Memorandum Findings of Fact and Opinion [App. pp. 11a-23a], designated T. C. Memo. 1962-248, Docket No. 82272, on October 23, 1962, and entered its Order and

[1] The following abbreviations are used herein: App.—Appendix hereto; Tr.—Transcript of the hearing before the Tax Court; Stip.—Stipulation; Ex.—Exhibit; R.—Record.

Decision [App. p. 23a] on October 25, 1962. The Findings and Opinion of the Tax Court are not officially reported, but are unofficially reported at 21 CCH TCM 1316 and at 31 P-H TCM ¶ 62,248.

The United States Court of Appeals for the Second Circuit handed down its decision [App. pp. 1a-8a] and entered its judgment [App. p. 9a] on June 28, 1963. The opinion of the Court of Appeals is reported at 319 F.2d 902.

II. JURISDICTION

The Court of Appeals for the Second Circuit entered its decision on June 28, 1963. Petitioner's petitions for rehearing and rehearing in banc timely filed on July 12, 1963, were denied on July 30, 1963. [App. p. 10a]. The Petitioner has complied with Rules 21 and 22, Revised Rules of the Supreme Court of the United States. The last day for filing this petition is October 28, 1963. This Court's jurisdiction to review the decision of the Court of Appeals on writ of certiorari is conferred by 62 Stat. 928, June 25, 1948, 28 U.S.C. § 1254 (1958 ed.); 68A Stat. 890, Aug. 16, 1954, 26 U.S.C. § 7482 (1958 ed.); 62 Stat. 961, June 25, 1948, 63 Stat. 104, May 24, 1949, 28 U.S.C. § 2101 (1958 ed.). See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); *Reo Motors, Inc. v. Commissioner*, 338 U.S. 442 (1950).

III. QUESTION PRESENTED

Where new stockholders, who, without any tax-avoidance purpose and solely for good business reasons, have purchased substantially all the stock of a coal mining corporation and have thereafter caused the corporation to sell its coal mining assets, and where it is first discovered about a year later that the sale of assets re-

sulted in a net operating loss which under all statutory provisions is allowable as a carryforward deduction, is there any extra-statutory rule precluding that same corporation from carrying forward and deducting that loss against income produced by electronics manufacturing assets thereafter purchased solely with the loss corporation's own cash and credit?

IV. STATUTES INVOLVED

(A) Internal Revenue Code of 1954, § 172, 26 U.S.C. § 172 (1958 ed.), 68A Stat. 63; Aug. 16, 1954, P.L. 85-866, 72 Stat. 1611, 1656, 1678, Sept. 2, 1958.

Petitioner's net operating loss deduction as claimed for 1954 is allowed under Subsection (a) of said Section 172 of the Internal Revenue Code of 1954, which provides in relevant part as follows:

> "There shall be allowed as a deduction for the taxable year an amount equal to . . . the net operating loss carryovers to such year. . . . For purposes of this subtitle, the term 'net operating loss deduction' means the deduction allowed by this subsection."

Section 172 as in effect for 1954 is set forth in full in the Appendix hereto, pp. 25a-32a.

(B) (1) Internal Revenue Code of 1954, § 269, 26 U.S.C. § 269 (1958 ed.), 68A Stat. 80, Aug. 16, 1954; (2) Internal Revenue Code of 1939, § 129, 26 U.S.C. § 129 (1952 ed.), 58 Stat. 47, February 25, 1944; (3) Internal Revenue Code of 1954, § 382(a), 26 U.S.C. § 382(a) (1958 ed.), 68A Stat. 129, Aug. 16, 1954. These statutory provisions are inapplicable, as discussed in text, but are relevant for that reason alone, and the pertinent portions thereof are set out in full in the Appendix hereto respectively at pp. 34a-35a, pp. 32a-33a, and pp. 36a-37a.

(C) The following Rulings of the Commissioner of Internal Revenue to which frequent reference is made, namely, *Rev. Rul. 58-603*, 1958-2 Cum. Bull. 147; *Rev. Rul. 59-395*, 1959-2 Cum. Bull. 475; and *Rev. Rul. 63-40*, 1963-12 Int. Rev. Bull. 8, are also set forth in full in the Appedix hereto respectively at p. 38a, pp. 38a-45a, and pp. 45a-48a.

V. STATEMENT OF THE CASE

The Tax Court disallowed Petitioner's net operating loss carryforward deduction from 1951 to 1954 and for that reason determined a deficiency in Petitioner's Federal income taxes for the year 1954 in the amount of $630,033.33 [App. p. 23a]. The Tax Court had jurisdiction under Internal Revenue Code of 1954, § 6213, 26 U.S.C. § 6213 (1958 ed.), 68A Stat. 771, Aug. 16, 1954, and Internal Revenue Code of 1954, § 6214, 26 U.S.C. § 6214 (1958 ed.), 68A Stat. 773, Aug. 16, 1954.

On Petitioner's appeal, the Court of Appeals for the Second Circuit affirmed the disallowance of the carryforward deduction and affirmed the determination of a deficiency. [App. p. 9a]. The Court of Appeals had jurisdiction under Internal Revenue Code of 1954, § 7482, 26 U.S.C. § 7482 (1958 ed.), 68A Stat. 890, Aug. 16, 1954.

There is no dispute that Petitioner sustained a net operating loss in the year 1951, as to the amount of such loss, or as to the amount of loss available for carryforward to the year 1954. There is no dispute as to the relevant facts.[2]

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[2] Except where the detailed Statement contains references to parts of the record herein, the facts are as found in the Memorandum of Facts and Opinion of the Tax Court which were adopted in toto by Respondent in his brief to the Court of Appeals.

(A) In very brief summary the facts are these:

In 1951, Lehman Brothers, pursuant to options substantially all of which were obtained in 1950, purchased about 95 per cent of the outstanding stock of Petitioner which for many years had engaged in coal mining. Lehman Brothers had no tax purpose of any sort for such purchase of stock and had no knowledge or awareness that any tax benefit of any sort might arise for possible future use. After the purchase of stock, Lehman Brothers caused Petitioner to sell substantially all its assets to an unrelated purchaser and to distribute a large part of the proceeds of sale. Approximately one year after that sale of assets and before Petitioner had received all of the sales price, it was for the first time discovered that Petitioner's sale of assets had resulted in a net operating loss. Thereupon Lehman Brothers decided to keep Petitioner in existence and to have Petitioner purchase operating assets to manufacture electronics products, such purchase being made solely with Petitioner's balance of the proceeds of the sale of its coal assets and with its own credit. To the extent that Petitioner's 1951 net operating loss from the sale of its coal assets was not absorbed by carryback to 1950 or carryforward to 1952 and 1953, Petitioner claimed that loss as a deduction against its 1954 profits from the manufacture and sale of electronics products.

(B) In relevant detail the facts are these:

Petitioner was incorporated under the laws of the State of Illinois on July 20, 1886. Petitioner continuously existed as the same corporate entity under Illinois law from its incorporation until after the end of the calendar year 1954 which is the taxable year before this Court.

From incorporation until February 28, 1951, Petitioner was engaged in the mining and sale of bituminous coal and in related activities some of which were conducted through subsidiary corporations. The name of Petitioner initially was "The Consolidated Coal Company of St. Louis." On February 20, 1935, this name was changed to "The Consolidated Coal Company," which continued as Petitioner's name until April 15, 1953.

In the Fall of 1950, an attorney, representing a decedent's estate which owned the largest single block of Petitioner's only outstanding class of stock (approximately 26,032), approached the New York investment banking firm of Lehman Brothers and suggested the possibility that Lehman Brothers might acquire a controlling interest in Petitioner's stock.

Petitioner's shares were not listed on any exchange and were traded only over-the-counter. Said decedent's estate could not have sold its shares at any acceptable price in the over-the-counter market because actual sales were few and purchasers were not available. [Tr. 61; Stip. 5; Tr. 79-80]. The attorney for said decedent's estate was not trying to sell the estate's shares to Lehman Brothers. Rather he was trying to persuade Lehman Brothers that, by a proper approach and offering price, a controlling block of stock could be purchased, which controlling block could be resold as a whole at a profit. [Tr. 61, 70-72, 76, 78-79, 255, 259]. After investigation of the possibilities of reselling a controlling block of Petitioner's stock, Lehman Brothers decided to proceed, but only on a basis which did not involve any commitment to Petitioner's stockholders and did not involve any financial risk for Lehman

Brothers, except for expenses of making the requests for options as mentioned below. [Tr. 82-83, 85-86].

Lehman Brothers then made arrangements with Bankers Trust Company of New York under which Bankers Trust Company, acting on behalf of Lehman Brothers as undisclosed principal, solicited options to purchase shares of Petitioner. [Ex. 25-Y]. In response to said solicitation, Bankers Trust Company received for Lehman Brothers options covering more than 80 per cent of Petitioner's stock before the end of the year 1950 [Stip. ¶11] and subsequently received options on additional shares.

Lehman Brothers did not intend to exercise said options unless it first could find an immediate purchaser for the shares. [Tr. 82, 255].

After the foregoing options had been obtained by Bankers Trust Company, Lehman Brothers began to search for a buyer of Petitioner's shares which were subject to such options. Following several unsuccessful attempts, Lehman Brothers did locate a potential purchaser, which was Zeigler Coal & Coke Company (hereinafter called "Zeigler"), an Illinois corporation engaged in operating coal mines in Illinois.

Prior to the transactions herein described, none of the directors or officers of Petitioner held any stock, partnership, management, employee or other interest in either Lehman Brothers or Zeigler, and neither Lehman Brothers nor any partner therein, nor Zeigler nor any substantial stockholder of Zeigler had any significant ownership of shares of Petitioner. [Stip. ¶8, Ex. 19-S].

Lehman Brothers' desire was to sell the stock of Petitioner and the negotiations between Lehman Broth-

ers and Zeigler initially resulted in an agreement that Lehman Brothers would sell and Zeigler would buy the optioned shares at a price which would yield Lehman Brothers a profit of $200,000. Before this agreement was incorporated into a formal written contract, Zeigler notified Lehman Brothers that the agreement would have to be revised so that Zeigler would buy Petitioner's assets and not Petitioner's stock. Lehman Brothers thereupon advised that it would be agreeable to such revision, provided that Lehman Brothers would realize the same $200,000 profit, and provided also that Lehman Brothers would not have to bear any expense that it would not have borne had it sold the stock. Zeigler agreed.

Thereafter, the Zeigler directors refused to approve the proposed transaction. [Tr. 118-119, 97-98]. Further negotiations followed and Lehman Brothers was forced to agree to a further revision to eliminate its $200,000 profit and to substitute therefor a profit contingent on the amount which Zeigler might subsequently realize from the sale of certain of Petitioner's properties which Zeigler did not propose to retain (referred to as the "disposable properties"). As revised, the agreement was approved by the Zeigler directors. [Tr. 97, 119]. The revised agreement was incorporated into a written agreement. [Ex. 31-EE; Stip. ¶ 17].

Lehman Brothers thereupon instructed its agent, Bankers Trust Company, to exercise the options to purchase shares of Petitioner's stock on behalf of Lehman Brothers. Between January 29, 1951, and February 28, 1951, Bankers Trust Company purchased for Lehman Brothers 47,447 shares of the 49,994 shares outstanding [Stip. ¶ 16] or approximately 94.9 per cent of all shares outstanding.

Pursuant to requisite corporate action of its directors and stockholders, Petitioner on February 26, 1951, entered into an agreement with Zeigler whereunder Petitioner agreed to sell substantially all its assets to Zeigler, subject to liabilities, for the price and on the terms previously agreed upon by Lehman Brothers and Zeigler. [Ex. 34-HHH].

Both the agreement between Lehman Brothers and Zeigler [Ex. 31-EE] and the agreement between Petitioner and Zeigler [Ex. 34-HHH] required that Petitioner be dissolved at some time in the future after Petitioner had received all of the purchase price including Petitioner's contingent share in the proceeds of the disposable properties. These provisions were inserted at the insistence of Zeigler because Zeigler was assuming contingent and unknown liabilities of Petitioner, including possible subsidence claims based upon the subsurface excavator's absolute duty to provide support to the surface owner, and Zeigler had been advised by its counsel that such claims would be cut off unless asserted within two years following dissolution of Petitioner. [Tr. 100, 105-106, 120-121]. Accordingly, on February 26, 1951, the directors and stockholders of Petitioner took requisite corporate action to authorize dissolution and on February 27, 1951, Petitioner filed with the Secretary of State of the State of Illinois its Statement of Intent to Dissolve at some unspecified time in the future. [Ex. 33-GG; Ex. 34-HHH; Stip. ¶ 29; Ex. 44-RR; Ex. 45-SS].

On February 28, 1951, pursuant to the agreement of February 26, 1951, Petitioner sold and conveyed to Zeigler all of Petitioner's assets except cash and United States Treasury obligations and received in partial payment therefor the agreed assumption of liabilities

plus an amount of cash which together with Petitioner's retained cash and Treasury obligations equalled $3,900,000. [Stip. ¶ 31]. Petitioner's contingent share of the proceeds of the sales of disposable properties was payable on periodic future dates when Zeigler was required to account for any sales it had made.

Upon receipt of the cash at closing on the above-mentioned sale, the directors of Petitioner declared and on the same day Petitioner paid a partial liquidating dividend of $76.50 per share ($3,824,541 on 49,991 shares). Lehman Brothers utilized its share of the dividend ($3,629,695.50 on 47,447 shares) to repay bank loans which had been incurred to purchase the shares of Petitioner and incurred to pay certain cash brokerage commissions in connection with said purchase of shares.

In May of 1951, the directors of Petitioner declared and Petitioner paid a second partial liquidating dividend of $1.50 per share. On December 31, 1951, Lehman Brothers paid out an amount equal to its share of this dividend ($71,170.50 on 47,447 shares) to complete payment of the aforesaid cash brokerage commissions. [Stip. ¶ 37; Ex. 53-AAA].

In June of 1951, Petitioner's capital structure was altered by reducing the par value of its stock from $100 per share to $1 per share and thereby reducing its stated capital from $5,000,000 to $50,000. This amendment was undertaken at the request of Zeigler in order to reduce the franchise taxes of Petitioner which were an expense payable by Zeigler. [Tr. 113].

After February 28, 1951, and to the end of the year 1951, Petitioner did not engage in active commercial operations except that the collection and payment of accounts receivable and accounts payable which had

been purchased or assumed by Zeigler were conducted in Petitioner's name by employees paid at Zeigler's expense, and except that two directors of Petitioner had communications with the president of Zeigler urging that Zeigler speed up the sale of disposable properties so that Petitioner could collect any contingent payments which would become due. By the end of 1951, no amounts had as yet become due to Petitioner in respect of disposable properties.

Following the end of the year 1951, Zeigler made an offer to Petitioner to purchase Petitioner's interest in the disposable properties for $250,000. Petitioner accepted. Under date of March 26, 1952, Petitioner and Zeigler entered into a supplemental agreement whereunder Zeigler agreed to pay Petitioner $250,000 in full settlement of the balance of the purchase price under their agreement dated February 26, 1951, and Petitioner agreed that upon receipt of that payment it would "immediately take steps to dissolve." [Stip. ¶ 56; Ex. 75-WWW]. The payment was made and received immediately after execution of the supplemental agreement.

Petitioner sustained a loss on the above-described sale of its coal mining properties to Zeigler, as a result of which Petitioner sustained a net operating loss for the calendar year 1951 in the amount of $3,466,387.52.

Sometime *after* February 25, 1952, approximately a year after Petitioner's sale of its coal assets, when Petitioner's certified public accountants submitted a draft of 1951 Federal income tax return, the officers and directors of Petitioner and the partners and employees

[3] All relevant income tax and loss figures have been stipulated [Stip. ¶ 44].

of Lehman Brothers responsible for Lehman Brothers' investment in Petitioner *first* became aware that Petitioner had suffered a loss on the sale of its coal properties and that said loss might be a net operating loss eligible for carryback and carryforward. [Tr. 124, 132-137, 139, 150-151, 228, 230-232, 237, 241-242, 244-245, 257-259; Stip. ¶43; Ex. 58-FFF].[4]

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[4] Lehman Brothers had no tax purpose of any kind in purchasing shares of Petitioner. Although the Tax Court found it unnecessary to make the specific ultimate finding of fact that neither Section 129 of the 1939 Code nor Section 269 of the 1954 Code applied, the findings of fact permit only that conclusion.

The Tax Court made the following findings in the order in which they are set forth:

(1) "... Lehman Brothers began to search for a buyer of such stock in the event it should decide to exercise such options." Thus Lehman Brothers sought a buyer to which it could resell Petitioner's stock, and Lehman Brothers did not contemplate causing Petitioner to sell its assets.

(2) "Lehman Brothers' desire was to sell the *stock* of [Petitioner] ...." The italicization of the word "stock" is by the Tax Court, emphasizing its finding that Lehman Brothers thought only of a resale of Petitioner's stock, and clearly holding that Lehman Brothers never contemplated causing Petitioner to sell its assets, and that Lehman Brothers never contemplated continuing as a stockholder of Petitioner. In such circumstances, the loss now claimed by Petitioner would never have arisen as a part of any transaction contemplated by Lehman Brothers because that loss arose on Petitioner's sale of its assets; and, on re-sale of the stock, any tax benefit obtainable in respect of Petitioner's excess of tax basis for its assets over a price a purchaser paid for Petitioner's stock would inure to the benefit of the purchaser of Petitioner's stock from Lehman Brothers, not to Lehman Brothers as the seller of the stock.

(3) "... in [Lehman Brothers'] preliminary negotiations with Zeigler, an informal agreement was reached to sell the shares which [Lehman Brothers] had under option ...." Lehman Brothers' complete lack of any contemplation of other than a stock sale was confirmed by its actions.

(4) "Later, however, Zeigler indicated that it would be interested only in buying [Petitioner's] assets, and not the stock." A

The Internal Revenue Service, after examination of Petitioner's 1951 return and after full disclosure that Petitioner was contemplating reversing dissolution proceedings and resuming active operations [Ex.

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sale of assets by Petitioner was thought of and initiated by Zeigler for Zeigler's own purposes.

(5) "Lehman Brothers thereupon advised that it would be agreeable to such a revised transaction, provided that it could realize the contemplated $200,000 profit, and provided also that it would not have to bear any expense that it would not bear if it sold the stock." The form was a matter of indifference to Lehman Brothers provided it came out with the same net profit as on a stock sale to which it had already agreed.

(6) "In February 1951, a statement of intent to dissolve [Petitioner] was filed on behalf of that corporation with the Secretary of State of the State of Illinois." Petitioner's loss on the sale of its coal assets would have terminated had Petitioner's existence been terminated by dissolution so Petitioner's stockholders still had no knowledge of the loss and no thought of its use when such statement was filed.

(7) "March 14, 1951: 4,447 shares were transferred to Emmanuel Becker, the attorney who had suggested to Lehman Brothers the acquisition of the [Petitioner's] stock . . . . The shares so transferred to Becker were intended to assure to Becker 10 percent of whatever profit Lehman Brothers might realize in final liquidation of [Petitioner]." This is a finding that almost seven weeks after the initial written agreement between Lehman Brothers and Zeigler (Exhibit 31-EE, dated January 26, 1951; Stip. ¶ (17)) and two weeks after closing on Petitioner's sale of its coal assets to Zeigler on February 28, 1951, Lehman Brothers still thought solely in terms of final liquidation of Petitioner and thus solely in terms of a profit to arise if at all from Petitioner's agreed share of the proceeds of "Disposable Properties." Thus there was still no knowledge by Lehman Brothers that Petitioner's sale of its coal assets created a net operating loss and still no thought of the use of such loss.

(8) ". . . two of the directors of [Petitioner] had some correspondence with the president of Zeigler, wherein they urged that Zeigler proceed with greater speed to sell the above-mentioned 'disposable properties,' in the proceeds of which [Petitioner] was to share after the amount thereof had reached $800,000.

111; Ex. 112; Ex. 113], approved the loss as a net operating loss and granted a refund of 1950 taxes based on the carryback of part of the 1951 loss. [Ex. 112; Ex. 113; Ex. 114; Stip. ¶ 50; Ex. 69-QQQ]. Illinois counsel advised that under Illinois corporation law the dissolution proceedings could be "reversed and can-

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By the end of the year 1951 Zeigler had realized approximately $790,000 from the sale of about 55 percent of such disposable properties." Clearly throughout the year 1951 Lehman Brothers was anxious for Petitioner to get all its money in hand so the money could be distributed in final liquidation. By the end of 1951, then, Lehman Brothers still had no knowledge of Petitioner's net operating loss and no thought of the use of such loss. Dissolution of Petitioner was delayed by the necessity of awaiting full payment, not for any reason of Lehman Brothers. However, by the end of 1951 the sale of disposable properties had not proceeded far enough to entitle Petitioner to any share of the proceeds. The provision for dissolution of Petitioner applied after Petitioner received all of the purchase price including its entire share of proceeds of disposable properties. (Stip. ¶ (22) (d); Ex. 34-HH). Zeigler did not finally complete realization on the disposable properties until 1954 or 1955. (Tr. 130).

(9) Under the supplemental agreement dated March 26, 1952, Petitioner agreed it would "immediately take steps to dissolve."

(10) "The officers of [Petitioner], upon receipt of the above-mentioned $250,000, began to consider the possibility of not proceeding further with the dissolution of the corporation, but rather of having said corporation enter into some new type of business." As the Tax Court found, the said $250,000 was paid to Petitioner on March 26, 1952. It was only on and after that date—a year and two months after the initial written agreement between Lehman Brothers and Zeigler—that Petitioner and Lehman Brothers first began to consider resuming activities rather than dissolving.

These findings, which are adopted by Respondent, clearly negative any purpose or intent by Lehman Brothers to create or obtain any net operating loss when Lehman Brothers bought Petitioner's stock for resale.

celled out." [Tr. 159]. The Internal Revenue Service determined that the distributions previously made by Petitioner in partial liquidation would retain their character as capital distributions under Section 115(c) of the Internal Revenue Code of 1939 even if the dissolution proceedings were reversed and cancelled out and Petitioner resumed active operations other than coal mining. [Ex. 113; Ex. 114; Ex. 69-QQQ].

On or after April 14, 1952 [Tr. 131], Petitioner undertook negotiations with Zeigler to have Zeigler waive the requirement that Petitioner be dissolved. About a year later, on April 2, 1953, Petitioner and Zeigler entered into a Second Supplemental Agreement whereunder Zeigler waived the requirement that Petitioner be dissolved, and Petitioner re-assumed its subsidence and other liabilities as to which no actions were commenced by June 15, 1954. [Stip. ¶ 57; Ex. 77-YYY].

In the Spring of 1952, the officers of Petitioner also began searching for a profitable going concern which Petitioner might buy solely with its own cash and own credit. Sometime in the Fall of 1952, the officers of Petitioner began negotiations with a representative of the stockholders of a 3-member group of corporations, Ketay Manufacturing Corp., Kinetix Instrument Co., Inc., and Ketay Research and Development Corp. (hereinafter collectively referred to as the "Ketay Companies"). None of the stockholders of the Ketay Companies had any prior relationship with Petitioner or Lehman Brothers. The Ketay Companies were engaged in developing, manufacturing and selling precision electronic components. These negotiations culminated in an agreement dated April 6, 1953, whereby Petitioner agreed to purchase all the outstanding shares of each of the three Ketay Companies for a total con-

sideration of $2,725,000 (later amended to $2,750,000), payable $100,000 in cash at the closing date, with the balance payable in installments on or before March 1, 1958. The down payment came solely from Petitioner's own previously held assets and was part of the proceeds of Petitioner's sale of its coal assets. The deferred installments were solely the debts of Petitioner and were in no way guaranteed or assured by any stockholder of Petitioner or by any other person. Petitioner's purpose in buying the stocks of the Ketay Companies was to obtain the assets of the Ketay Companies.

Concurrently with the execution of the stock purchase agreement of April 6, 1953, Petitioner and the selling stockholders of the Ketay Companies entered into a second agreement whereunder Petitioner agreed it would increase the number of its authorized shares from 50,000 to 75,000 and that it would issue and sell (at a price of 5¢ each) to the Ketay stockholders warrants entitling them to purchase the additional 25,000 shares of Petitioner's common stock at a price of $4.95 per share.[5]

Preparatory to closing under the Ketay agreements, the following occurred. On March 30, 1953, the Secretary of State of the State of Illinois issued his certificate that Petitioner was still in Good Standing as a domestic corporation of the State of Illinois. On April 7, 1953, pursuant to applicable corporate procedures, the stockholders of Petitioner adopted a resolution that the voluntary dissolution proceedings, previously begun, should be revoked. On April 9, 1953, Petitioner

[5] The total of $5.00 per share was approximately equal to the underlying net assets value of Petitioner's shares at the time, i.e., the $250,000 in cash received from Zeigler divided by 50,000 authorized shares.

filed with the Secretary of State of the State of Illinois a "Statement of Revocation of Dissolution Proceedings," and said Secretary of State duly issued his Certificate of Filing thereof. Also on April 9, 1953, Petitioner amended its articles of incorporation (1) to expand its purposes, (2) to increase its authorized number of shares from 50,000 to 75,000, and (3) to abrogate pre-emptive rights.

On April 15, 1953, closing took place under the aforesaid agreements between Petitioner and the Ketay stockholders, and Petitioner thereupon acquired all of the outstanding capital stock of all three Ketay Companies. Immediately thereafter, on the same day, Petitioner caused each of the Ketay Companies to file its certificate of dissolution with the Secretary of State of the State of New York. Also on the same day Petitioner changed its name to "Ketay Manufacturing Corp." On the following day, April 16, 1953, the Secretary of State of the State of New York dissolved all three Ketay Companies, and Petitioner thereupon became the owner of all assets and properties previously owned by the Ketay Companies.[5] Petitioner's principal office became New York City. Following April 16, 1953, and until July 1, 1958 [Stip. ¶ 80], Petitioner continuously engaged in substantially the same activity as had previously been conducted by the Ketay

[5] Petitioner purchased the stock of the Ketay Companies solely to get their assets, and Petitioner immediately dissolved the Ketay Companies and got direct ownership of their assets. Petitioner is to be treated for all purposes as having purchased the assets of the Ketay Companies. *Kimball Diamond Milling Company*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951); *United States* v. *M. O. J. Corporation*, 274 F.2d 713 (5th Cir. 1960).

Companies, i.e., the development, manufacture and sale of precision electronic components.

On August 31, 1953 [Stip. ¶ 70; Ex. 101-BAW], all of the above-described stock warrants which had been issued to the former Ketay stockholders were exercised by them or by others to whom the warrants had been transferred.

On November 2, 1953, Petitioner's authorized common stock was changed and increased from 75,000 shares of $1 par value to 850,000 shares of 10¢ par value and each existing share became 10 new shares. On June 22, 1954, Petitioner's authorized common stock was increased to 2,000,000 shares. On September 10, 1954, Petitioner's name was changed to "Ketay Instrument Corporation." On September 29, 1954, 300,000 shares of Petitioner (consisting in part of authorized but unissued shares being sold by Petitioner and in part of issued shares being sold by stockholders[7]) were sold to the public through underwriters. On February 11, 1955, following a merger which is not in question here, Petitioner changed its name to "Norden-Ketay Corporation."

As stipulated [Stip. ¶ 44], for 1951 Petitioner had a net operating loss of $3,466,387.52, arising from its previous activity of mining and selling bituminous coal. Of this loss, the amount of $207,839.15 was absorbed by carryback to 1950. For 1952, Petitioner had a net operating loss of $5,869.02. For 1953, Petitioner had adjusted net income of $1,108,410.66, before net operating loss carryforward, all of which net in-

[7] The shares sold were not, as recited by the Tax Court below, all newly authorized shares being sold by Petitioner. [Ex. 104-BAZ; Stip. ¶ 76].

come arose from the manufacture and sale of electronic components following Petitioner's purchase of assets of the Ketay Companies. The 1953 electronics income was offset by an equal amount of the 1951 coal loss carryforward, and Petitioner's 1953 return is not in question. Petitioner's balance of unused 1951 coal loss available for carryforward to 1954 is $2,150,137.71 which exceeds Petitioner's stipulated electronics income for 1954 before net operating loss carryforward.

VI. REASONS FOR GRANTING THE WRIT

This petition for certiorari should be granted because:

(A) the decision of the Court of Appeals for the Second Circuit is in direct conflict with the decision of the Court of Appeals for the Ninth Circuit on indistinguishable facts in *Hawaiian Trust Company, Limited* v. *United States*, 291 F.2d 761 (9th Cir. 1961); and the decision of the Court of Appeals for the Second Circuit in the present case reaches that conflicting position because the Court of Appeals completely misconstrues and misapplies the decision of this Court in *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382 (1957); and because

(B) the issue is of current importance to corporate taxpayers generally and the conflict and confusion fostered by the decision of the Court of Appeals for the Second Circuit in the present case should be resolved and clarified by this Court.

(A)

The decision of the Court of Appeals for the Second Circuit in the present case is in direct conflict with the decision of the Court of Appeals for the Ninth Circuit

on indistinguishable facts in *Hawaiian Trust Company, Limited* v. *United States, supra*.*

In *Hawaiian Trust*, a corporation referred to as Refiners purchased 96 per cent of the stock of Hilo Gas during October of 1950, pursuant to options previously acquired. Refiners had no tax avoidance purposes of any sort for the acquisition. On October 31, 1950, pursuant to earlier arrangements, Hilo Gas sold its utility assets, which were substantially all its assets, to Honolulu Gas; a corporation the stockholders of which appear to have been substantially the same as the stockholders of Refiners. Honolulu Gas also assumed the liabilities of Hilo Gas. Some remaining assets were sold to Refiners at the same time. Thereafter, Hilo Gas, with only insignificant exceptions, had only the proceeds of the sales, most of which were lent to its new parent Refiners, and no liabilities.

At the time Refiners purchased the stock of Hilo Gas, it was intended and arranged to sell the public utility assets of Hilo Gas to Honolulu Gas, to sell the remaining assets to Refiners, and "to dissolve the corporation [Hilo Gas] at such time as the directors of that company determined in their discretion to be convenient." In November, 1950, the month *following* acquisition of the Hilo Gas stock and the sale of the Hilo Gas assets, Refiners was advised that the sale by Hilo Gas of its utilities properties to Honolulu Gas resulted in an allowable net operating loss. Thereafter, Hilo Gas was kept in existence and its loss used

* Petitioner argued and briefed the *Hawaiian Trust Company* case to the Court of Appeals for the Second Circuit and again pointed to the case in a Petition for Rehearing but the Court of Appeals for the Second Circuit declined to attempt to distinguish the case and did not even cite it.

as a net operating loss carryforward on consolidated returns filed by Refiners and Hilo Gas. From the sale of its assets in 1950 until its dissolution in 1956, Hilo Gas had no significant commercial activities. The loss of Hilo Gas was suffered on the sale of its assets used as a regulated public utility which manufactured and distributed gas through mains. The income of Refiners for 1953, against which the 1950 loss of Hilo Gas was claimed as a carryforward deduction, arose from an entirely different commercial activity as a non-public utility refining and selling petroleum products and selling bottled gas.

In *Hawaiian Trust*, the Court of Appeals for the Ninth Circuit held the loss allowable. On indistinguishable facts in the present case, the Court of Appeals for the Second Circuit held the loss not allowable.

(1) The Court of Appeals for the Ninth Circuit deemed it irrelevant that the loss which arose from one type of commercial activity was offset against income from another type of activity; this was the "first and most obvious factor" in the conflicting decision in the present case.

(2) The Court of Appeals for the Ninth Circuit deemed it irrelevant that there had been a 96 per cent change in stock ownership *prior* to the time the loss arose, since the change in stock ownership was not undertaken by the purchaser for any tax avoidance purpose; the Court of Appeals for the Second Circuit, in its conflicting decision in the present case found that a 94.9 per cent change in stock ownership *prior* to the time the loss arose was "the second major factor" in its disallowance of the loss even though the change of stock ownership was not undertaken by the purchaser for any tax avoidance purpose.

(3) The Court of Appeals for the Ninth Circuit held that the only question was whether Refiners' acquisition of the Hilo Gas stock was for a tax avoidance purpose and further held that post-acquisition events were not relevant. Thus the Court of Appeals for the Ninth Circuit found it irrelevant that it had been intended to dissolve Hilo Gas, that steps to dissolve Hilo Gas had been initiated and that Hilo Gas had no significant commercial activities, as well as finding that it was irrelevant whether the income against which the loss was used arose from the same activity as the loss. The Court of Appeals for the Second Circuit in its conflicting opinion in the present case held that all these same post-acquisition events could support its disallowance of the loss even though Lehman Brothers' acquisition of Petitioner's stock was not for a tax avoidance purpose.

(4) The Court of Appeals for the Ninth Circuit held that the tax benefit innocently acquired by Refiners in its purchase of stock of Hilo Gas, even if called a "windfall", was properly allowable even though the decline in value of the Hilo Gas assets may have occurred prior to Refiners' purchase of the Hilo Gas stock so that the loss was borne by the sellers of the stock; the Court of Appeals for the Second Circuit in its conflicting opinion in the present case held that the tax benefit innocently acquired was not allowable, even though plainly within the statute, and gave as a reason that the "ultimate incidence" of the loss did not fall on Lehman Brothers as purchasers of the stock after the decline in value of the coal assets must have occurred.

These are the operative points of decision in the two cases and the two decisions squarely conflict. This conflict should be resolved.

The Court of Appeals for the Second Circuit reached its conflicting position in the present case because it completely misconstrues and misapplies the decision of this Court in *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957). The stated grounds of the Court of Appeals below are some new kind of *Clifford*[9] doctrine involving a compound of an undeterminable number of degrees of change in the nature of corporate activity, and an unspecifiable number of percentages of change in ownership of stock—a test incapable of statement except in the vaguest generalities. As precedent the Court of Appeals for the Second Circuit cites this Court's decision in *Libson Shops*.

It is submitted that the *Libson Shops* decision had nothing whatever to do with either the nature of the corporate activities or any changes therein, or with any ultimate beneficial ownership of stock or changes therein. At the outset it should be noted that in *Libson Shops* exactly the same commercial activities were carried on continuously at all relevant times and the ultimate beneficial ownership of stock was exactly the same at all relevant times. The unchanging continuance of the same activities and of the same stock ownership did not save the loss in that case because neither had anything to do with that case.

In *Libson Shops* this Court was required to determine whether and under what circumstances a net op-

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[9] *Helvering* v. *Clifford*, 309 U.S. 331 (1940), taxing to the grantor the income of a short term trust because his retained powers and retained "bundle of rights" were found to constitute retention of dominion and control and substantial ownership. Much litigation followed. Congress has now overruled *Clifford* and prescribed a set of specific and objective tests. Internal Revenue Code of 1954, Sections 671-677.

grating loss of a constituent corporation would be available as a carryforward loss to the surviving corporation after a tax-free merger. The previous decisions of this Court and the lower courts, in some cases concerning net operating losses and in some cases concerning other kinds of tax characteristics, had developed three possibilities: (1) that a loss carryforward never survived regardless of the form of corporate amalgamation;[10] (2) at the opposite extreme, that a loss carryforward always survived a tax-free merger, regardless of the previous relationship or lack of relationship of the constituent corporations;[11] and (3) in the middle, that a loss carryforward survived a tax-free amalgamation provided that the constitutent corporations had previously been related (parent-subsidiary or so affiliated that consolidated returns could have been filed) and provided that the loss arose while the constituent corporations were so related.[12]

The *Libson Shops* case presented to this Court only the question of which of these three possibilities was the proper application of the law to find the identity of

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[10] Based on *New Colonial Ice Company* v. *Helvering*, 292 U.S. 435 (1934).

[11] Based on *E. & J. Gallo Winery* v. *Commissioner*, 227 F.2d 699 (9th Cir. 1955), *rev'g* 12 CCH TCM 414, 22 P-H TCM ¶ 53,131 (1953).

[12] Based on *Helvering* v. *Metropolitan Edison Company*, 306 U.S. 522 (1939); *Koppers Company, Inc.* v. *United States*, 134 F. Supp. 290 (Ct. Cl. 1955), *cert. denied*, 353 U.S. 983 (1957); *The Stanton Brewery, Inc.* v. *Commissioner*, 176 F.2d 573 (2d Cir. 1949); *Hughes Tool Company* v. *Commissioner*, 147 F.2d 967 (5th Cir. 1945); *Early* v. *Southgate Corporation*, 136 F.2d 217 (4th Cir. 1943); see also *Newmarket Manufacturing Company* v. *United States*, 233 F.2d 493 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957).

"the taxpayer" which was entitled to a carryforward of its own loss.

In the *Libson Shops* case there had been 17 separate corporations, all of the outstanding stock of which was owned directly or indirectly by the same 8 individuals and in the same proportions. The corporations were not in the relationship of parent and subsidiaries, nor were they so affiliated as to be entitled to file consolidated returns. Sixteen of the corporations were engaged in selling women's apparel at retail at different locations. The other corporation acted as the management corporation. Pursuant to a statutory merger, all 17 corporations were merged and the former management corporation was the emerging corporation. Following the merger, the emerging corporation continued to conduct the same commercial activities as had previously been conducted by all of the constituent corporations and at the same locations. Prior to the merger, three of the sales corporations had sustained net operating losses and in the year following the merger each of the three retail units formerly operated by these three loss corporations continued to show losses, although the total operations of the emerging corporation showed a profit. The emerging corporation claimed the deduction by carryforward against post-merger profits of the pre-merger net operating losses of the three loss constituent corporations. The sole question presented to this Court was whether the emerging corporation was the same "taxpayer" as its pre-merger loss components so as to be entitled to carryforward against post-merger profits "its" pre-merger losses.

The primary contention of the Government was that separately chartered corporations are never the same

taxable entity as the emerging corporation could not be the same "taxpayer" as its submerged loss constituents—the first of the three possibilities mentioned above. The primary contention of the taxpayer was that a corporation resulting from a tax-free statutory merger is always the same taxable entity as its constituents without regard to the pre-merger relationships because the corporate existence of all constituent corporations continues within the emerging corporation—the second alternative to the opposite extreme from the first. This Court found it unnecessary to discuss the issue created by these primary contentions of the parties because this Court adopted the third possibility, the middle ground, as the correct rule.

Thus this Court held that, following a tax-free merger, the emerging corporation would be the same "taxpayer" as the constituent corporations, for purposes of carrying forward pre-merger losses against post-merger profits, if (and only if), prior to the merger and during the time the losses arose, the constituent corporations had been parent and subsidiaries or so affiliated as to be entitled to file consolidated returns. Under such circumstances, pre-merger there would have been a single "pool" of stockholder risk insofar as the ultimate stockholders were concerned, in which case this Court viewed revisions in the number of corporate entities within that single pool as irrelevant, and the single "pool" remained a single "taxpayer" even though the number of corporate entities within that pool were reduced by merger. That single "pool" of ultimate stockholder risk would be "a continuous enterprise" and there would be a "continuity of business" even though the number of corporate sub-pockets were changed. On the other hand, if pre-merger there

were multiple pools of stockholder risk, i.e., the constituent corporations were not parent-subsidiary and were not affiliated for consolidated return purposes, this Court held that the stockholders should not retroactively be able to rearrange their affairs so as to be able to put into a single pool their profits and losses which had arisen in separate pools. In *Libson Shops*, there had been multiple pre-merger pools, so the emerging corporation was not the same "taxpayer" as its constitutents and could not use their pre-merger losses.

This holding of *Libson Shops* and the distinction made are entirely sound. At the outset, the organizers in *Libson Shops*, having decided to operate in corporate form, had alternatives as to how to set up their organization. Each alternative had its Federal income tax advantages and its Federal income tax disadvantages.

On the one hand, they could have conducted all operations through a single corporation or through a parent and wholly-owned subsidiaries. In this case, funds from a profitable store could be used to finance a losing store or to start a new store without those funds having to be transferred first as taxable dividends to individual stockholders and then as contributions to capital. Losses of one store could be deducted currently against profits of other stores if there were a single corporation or if the parent and subsidiaries filed a consolidated return. However, the single corporation or the parent and subsidiaries filing a consolidated return would be entitled to only a single $25,000 corporate surtax exemption and all net profits over $25,000 would then be subject to both corporate normal tax and corporate surtax the combined rate of which is presently 52 per cent. Also, if, for example,

one store were sold, a corporate tax on the profit could not be avoided without a corporate liquidation of the whole enterprise, which would require a tax at that time on all increment in value of the total enterprise; and, absent a liquidation, the proceeds of the sale of one store could only be distributed as a dividend and not as a capital gain unless the total enterprise had no earned surplus.

On the other hand, the organizational form adopted, of individual stock ownership of a number of corporations each having one store, achieved the opposite tax result on each of the above points. The advantages above were disadvantages: funds could not be moved from one store to another except after being paid out as taxable dividends to the individual stockholders; losses of one corporation could not be deducted currently against profits of another corporation and could be deducted by carryback or carryforward only against any prior or subsequent profits of that loss corporation. At the same time, each separate corporation had its own $25,000 surtax exemption so that the 17 corporations in total could have profits of $425,000 taxable only at the normal tax rate (now 30 per cent) before getting into corporate surtaxes (another 22 per cent). Also, if one separate store were sold, that separate corporation would not have to pay any tax on its profit, and it could be arranged that there would be only a single tax at capital gains rates when those proceeds were distributed to the individual stockholders. The organizers in *Libson Shops* sought these advantages and accepted the disadvantages.

If, solely because of the merger, *Libson Shops* had permitted a post-merger deduction of pre-merger losses, the stockholders would thereby retroactively

have achieved a netting of profits and losses which was not allowable under the organizational form originally selected. A merger alone should not retroactively create such a tax advantage. Congress certainly cannot have intended any result except the precise result achieved by this Court in *Libson Shops*.

But the *Libson Shops* opinion had nothing whatsoever to do with the nature of the commercial activities or with the ultimate beneficial stock ownership. Both remained unchanged across the line of corporate merger in *Libson Shops* yet this unchanging continuance did not save the *Libson Shops* loss since neither had anything to do with the case. *Libson Shops* is incorrectly cited for any proposition concerning the nature of or any change in commercial activities or ultimate beneficial stock ownership. The "test" conjured by the Court of Appeals for the Second Circuit below is groundless.

The Court of Appeals for the Second Circuit misreads *Libson Shops* as establishing and supporting an "activities—stock ownership" test despite the fact that this Court in its *Libson Shops* opinion went out of its way to specify that that opinion had nothing to do with any such possible test. In footnote nine to the *Libson Shops* opinion (353 U.S. at 390), this Court stated:

> "We do not pass on situations like those presented in *Northway Securities Co.* v. *Commissioner*, 23 B.T.A. 532; *Alprosa Watch Corp.* v. *Commissioner*, 11 T.C. 240; *A. B. & Container Corp.* v. *Commissioner*, 14 T.C. 842; *W & G E, Inc.* v. *Commissioner*, 19 T.C. 249. In these cases a *single* corporate taxpayer changed the character of its business and the taxable income of one of

its enterprises was reduced by the deductions or credits of another."

It is unquestionably clear that this Court did *not* pass on and made *no* holding with respect to the *only* point for which the Court of Appeals in the present case cites *Libson Shops* as precedent! And without the Court of Appeals' erroneous view of *Libson Shops*, there is no precedent or substantiation for the decision in the present case.

(B)

The issue is of current importance to corporate taxpayers generally and the conflict and confusion fostered by the decision of the Court of Appeals for the Second Circuit in the present case should be resolved and clarified by this Court. The issues of the conflict with *Hawaiian Trust* and the erroneous construction and application of *Libson Shops* are squarely presented here, are of broad interest, and of major current importance.

There is widespread confusion. The meaning of the *Libson Shops* decision is plain as discussed above, but the imprecise language at points in that opinion permitted some uncertainty. This Court's use of the words "business" and "businesses" did not make it clear which of a great many possible meanings was intended for each word. The Commissioner of Internal Revenue, with considerable unanalytical indulgence of some courts, has then taken these words out of context to create muddled arguments about some "principle" precluding a change in the nature of commercial activities. The Commissioner is not certain what he thinks that "principle" is, or at least is not consistent in defining or applying it, but he is certain he has something which is a fine club.

The Commissioner's misuse of this Court's opinion is not justified, but—in the unlikely event that any such development as this could have been foreseen at the time—if this Court's opinion in *Libson Shops* had been tightly written with precise words, there would have been no starting point for all this confusion.

The Commissioner's first pronouncement, somewhat more than a year after this Court's decision, was that the "principle" of *Libson Shops* "will not be relied upon by the Internal Revenue Service under the Internal Revenue Code of 1954 . . ." *Rev. Rul. 58-603*, 1958-2 Cum. Bull. 147 (TIR 89, 8-25-58) [App. p. 38a]. However, despite the Commissioner's announcement, his representatives in the examination of returns and the argument of cases did not confine their arguments about the "principle" of *Libson Shops* to 1939 Code cases, but have applied their "principle" equally to all years including 1954 Code years.

The Commission's representatives also considerably extended the Commissioner's originally announced view as to the "principle" of *Libson Shops*. In *Rev. Rul. 59-395*, 1959-2 Cum. Bull. 475 [App. pp. 38a-45a], the Commissioner expressed his view as (1) that no carryforwards or carrybacks were allowable across the line of a corporate fusion effected other than by a statutory merger or consolidation and (2) that in cases of statutory mergers or consolidations only the income and losses from the same *assets* could be netted —two astonishing conclusions to draw from *Libson Shops*. But even this "principle" expanded rapidly and the necessity for any form of corporate fusion was soon dropped. The position became that, without any corporate fusion of any sort, and with only a single corporate taxpayer, losses could be offset only against

income of the same assets that produced the loss—nothing else was required for the Commissioner to deny the loss except the fact that the physical sources of the loss and the profit were not the same. Allegedly *Libson Shops* was authority for this view.

This argument, in various stages of its development, has been made to lower courts by the Commissioner's representatives. Until the present case, the lower courts seem generally to have achieved the right result, but the courts on occasion have included some of the language by which the Commissioner's representatives represented the *Libson Shops* holding as concerning a change in the nature of commercial activities and later as also concerning changes in stockholdings.

Encouraged by the language in some of these opinions, the Commissioner's representatives have pushed their version of *Libson Shops* to the extreme. For example, a loss corporation invested part of its assets in stock of a non-controlled corporation, apparently a passive investment. The Appellate Division refused to allow the loss carryforward against dividend income. *Tax Management Memorandums*, July 9, 1962, p. 6. A manufacturing corporation sold all operating assets after suffering severe financial losses and invested the proceeds in a joint venture conducting a service activity. The Internal Revenue Service denied the carryforward deduction. *Tax Management Memorandums*, September 3, 1962, p. 5.

The positions advanced became so extreme that the Section of Taxation of the American Bar Association felt it necessary to recommend a specific amendment to Section 172 of the 1954 Code, which relates to net operating loss carrybacks and carryforwards, to pro-

vide that "the amount of the [net operating loss] deduction . . . for any taxable year shall not be reduced by reason of the fact that the net operating loss carryovers and carrybacks to such year are attributable in whole or in part to activities different from the activities carried on during such taxable year." The Section of Taxation proposed that such specific amendment should be made retroactive to all 1954 Code years because of "the evident intent of Congress in enacting the 1954 Code that a continuity of business enterprise test should not be applicable except in situations covered by § 382(a)." *Program and Committee Reports, 1962*, Section of Taxation, American Bar Association, pp. 47-49.

Early this year the Commissioner retreated slightly from the extreme position that, without more, losses from one set of assets or activity could be netted only against income from the same set of assets or activity. The "principle" of *Libson Shops* could hardly have changed, but, borrowing the general approach of Congress in Section 382(a) of the 1954 Code, the Commissioner now says that, under the alleged authority of *Libson Shops*, and for a single corporation even in the absence of any merger, where there is "more than a minor change in stock ownership", a loss may not be carried forward against the income of a "new business activity." *Rev. Rul. 63-40*, 1963-12 Int. Rev. Bull. 8 (TIR 456, March 4, 1963) [App. pp. 45a-48a]. The scope of application of the Commissioner's statute is precisely the same as the act of Congress, yet the Commissioner gets different results.

The Commissioner's new "principle" is stated to be applicable to all 1954 Code years, as a part of some

common law of Federal income taxation. *Rev. Rul. 63-40*.

Rev. Rul. 63-40 is legislation by the Commissioner in direct competition with Congress' statute on the same subject. The Court of Appeals in the present case adopted the Commissioner's statute to disallow Petitioner's loss which loss would not have been disallowed by Congress' statute.

In Section 382(a) of the Internal Revenue Code of 1954, Congress provided specific rules under which net operating loss carryforwards otherwise allowable under the general statutory provisions should nevertheless be disallowed. Congress was well aware of the problems created (and later cured) by certain court decisions[18] under Section 129 of the 1939 Code and Section 269 of the 1954 Code relating to acquisitions where there was a principal purpose of tax avoidance [App. pp. 32a-35a], and Congress was also aware of problems of proving the subjective intent required by those Sections. So, in the 1954 Code, after providing in broad terms for net operating losses (and other tax attri-

[18] Originally it had been held that, even where the new stockholders conceded that they acquired the stock of an empty shell loss corporation only to get the loss, Section 129 of the 1939 Code did not disallow the loss to the corporation, the ground being that Section 129 applied only to an acquiring and not to an acquired corporation. *See Alprosa Watch Corporation*, 11 T.C. 240 (1948); *British Motor Car Distributors, Ltd.*, 31 T.C. 437 (1958). The Court of Appeals for the Fifth Circuit held contrary to the Tax Court on this point in *Mill Ridge Coal Company* v. *Patterson*, 264 F.2d 713 (1959), *cert. denied*, 361 U.S. 816 (1959), and the Court of Appeals for the Ninth Circuit then reversed the Tax Court in *British Motor Car Distributors*, 278 F.2d 392 (1960). The Tax Court accepted the new rule in *Thomas E. Snyder Sons Co.*, 34 T.C. 400 (1960), *aff'd*, 288 F.2d 36 (7th Cir. 1961). But *Alprosa Watch* was the decisional law when the 1954 Code was enacted.

butes) to continue to be available generally following innumerable types of transactions, Congress then set forth specific rules for disallowance, despite the general rules and without regard to whether there was any tax avoidance purpose, in cases where Congress found that there might be possibilities of unintended uses of losses. Thus, in 382(a) of the 1954 Code, Congress provided that, if there were the specified percentage change in stock ownership of a corporation, and if the "trade or business" of that corporation underwent the specified change within the specified period, net operating losses from prior years would not be allowed.

Rev. Rul. 63-40 covers precisely the same subject matter and uses the same approach, but the Commissioner disagrees with Congress as to the standards. Thus Congress requires at least a 50 percentage points change in stock ownership within a period of two taxable years; the Commissioner questions "more than a minor change in stock ownership" without any specified percentage and without any time limitation. Congress requires that there be the specified change in the trade or business prior to the end of the taxable year following the taxable year of change of stock ownership; the Commissioner requires only that there be a "new business enterprise" which might be of the same nature as or in addition to or in place of that previously operated, and the Commissioner has no time limit. Congress felt it necessary to deal only with losses arising in the year of change of stock ownership and years prior thereto; the Commissioner looks at losses thereafter arising before the acquisition of the "new business enterprise."

It is respectfully submitted that, when Congress and the Commissioner legislate on the same subject, the

act of Congress occupies the field. And the statute as enacted by Congress would not disallow this Petitioner's loss."[11]

This Petition does not ask this Court to assist tax avoidance or trafficking in tax losses. To the contrary, this Court is asked to correct an erroneous "doctrine" which started with a misreading of a few words in the *Libson Shops* opinion and which with careful nourishment by the Commissioner has ballooned into a vigorous statute competing effectively with an act of Congress. The Commissioner, with the tolerance of some lower courts, such as the Court of Appeals in the present case, has injected uncertainty into numberless legitimate commercial transactions on the precise points where Congress by express legislation intended to provide certainty. Even tax "experts" are unable to advise businessmen with any assurances as to what the Commissioner's position is or will be next.

Net operating losses do not *per se* involve tax avoidance. In the overwhelming number of instances the

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[11] Under Section 394(b), 1954 Code, 68A Stat. 13f, Aug. 16, 1954, Section 382(a) does not apply in respect of changes of stock ownership prior to June 22, 1954, even though, as in the present case, a loss carryforward is claimed under the 1954 Code. However, even if Section 382(a) had been fully effective for all years possibly relevant to the present case, Section 382(a) would not have disallowed Petitioner's claimed loss. Section 382(a) disallows only losses arising in the year of change of stock ownership and in years prior thereto. This Petitioner's loss arose in its taxable year 1953 which was the year following the taxable year 1950 in which by options (Section 382(a)(3), Section 318(a)(3)) Lehman Brothers acquired over 80 per cent of the stock of Petitioner. Also in 1953 and 1954, when Petitioner operated the assets purchased from the Ketay Companies, there was not a change in stock ownership of as much as 50 percentage points as required by Section 382(a).

aims of Congress are plainly achieved to provide, under our annual accounting system for income taxes, an income averaging for enterprises with cyclical or sporadic income. New enterprises have starting-up losses; existing enterprises experience losses when expanding in the same or different lines; some enterprises, particularly capital goods industries, are cyclical. Many companies by adopting the Treasury's new depreciation guidelines (*Rev. Proc. 62-21*, 1962-2 Cum. Bull. 418) and by using faster methods of depreciation (Section 167(b)(2), (3) and (4) of the 1954 Code)—both designed to encourage plant renovation and development of new industrial activities—may frequently create net operating losses. Congress, in defining the net taxable income of these enterprises for annual accounting purposes, provided for carrybacks and carryforwards to achieve an averaging. For example, in the Revenue Act of 1939, Congress provided for a two-year carryforward of net operating losses, explaining in part:

> "New enterprises and the capital-goods industries are especially subject to wide fluctuations in earnings. It is, therefore, believed that the allowance of a net operating business loss carry-over will greatly aid business and *stimulate new enterprises*." *H.R. Rep. No. 855*, 76th Cong., 1st Sess. 9 (1939) (emphasis added).

The Revenue Revision Act of 1948 amended the net operating loss provision to provide for a one-year carryback and a five-year carryforward, which changes were explained in part:

> "This reduces the tax disadvantages of businesses with fluctuating incomes. Since these incomes are associated with unusual business risks and occur

"with relatively great frequency among small and *new businesses*, the extension of the averaging period will provide an *additional stimulus to venture capital generally*. . . .

". . . The emphasis on the carryforward is to the marked advantage of *new business*. . . . *Established businesses undergoing a material expansion are favored by the change*." *H.R. Rep. No. 2087*, 80th Cong., 2d Sess. 2-3 (1948) (emphasis added).

There is no suggestion here that a loss from one type of activity could be netted only against income of the same activity. Rather losses would offset income of "new enterprises" and of "material expansion" whether in the same or a different activity.

This is particularly important today with many enterprises bearing high research and development costs and many experiencing heavy costs from rapid obsolescence. An explosives manufacturer today would not be encouraged as Congress intends to undertake heavy research and development costs to create new products such as nylon if losses from research and development could not be offset against income from nylon which is primarily used for clothing and fabrics. Yet, if the company's stock is listed and traded on a stock exchange with "more than a minor change in stock ownership" over some unspecified period, *Rev. Rul. 63-40*, the Commissioner's statute would kill the loss. Congress' statute would allow the loss unless there were a new more-than-50 per cent controlling group of ten stockholders which group acquired that control within a specified limited period. A manufacturer of propeller-driven manned airplanes could not afford to scrap his obsolete equipment and make heavy investments in equipment to manufacture rockets if

his loss on the scrapping of the old machines could not be set off against income from manufacture of rockets. Yet, if there were "more than a minor change in stock ownership" even for a listed company, the Commissioner's statute, *Rev. Rul. 63-40*, would disallow the loss.

Congress provided broadly for loss carrybacks and carryforwards and for such losses to survive many types of corporate transactions. Then, in Sections 382 and 269, Congress dealt specifically with those cases in which, after careful study, Congress determined that allowance of the loss would not accord with Congressional policy. Congress has specifically drawn the lines, and has not left the line-drawing either to the Commissioner or to the Courts. The separate and different rules of the Commissioner, applied as in the present case by the Court of Appeals for the Second Circuit, are unwarranted.

VII. CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted.

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